

**Testimony of Steven T. Miller
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Internal Revenue Service
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I. Introduction

Chairman Ramstad, Ranking Member Lewis and members of the Subcommittee, I appreciate the opportunity to testify this morning on the Internal Revenue Service's enforcement efforts with respect to charities' payment of employment taxes.

I am the Commissioner, Tax Exempt and Government Entities (TE/GE). TE/GE is one of four operating divisions at the IRS. We have principal responsibility for tax-exempt entities. In addition to the charities that are the subject of today's hearing, we are also responsible for other tax-favored entities: qualified retirement plans, all types of tax-exempt organizations, tax-exempt bonds, Indian tribal governments, and federal, state and local governments in their role as employers, which makes them responsible for employment taxes.

In addition to discussing what my division, TE/GE, does to enforce the law with respect to charities' employment tax obligations, I will also discuss this morning the role played by another of our operating divisions in detecting and collecting employment taxes from charities. This is the Small Business/Self Employed division (SB/SE). As will be apparent, SB/SE plays a major role within the IRS in enforcing the tax law as it relates to employment taxes.

The IRS appreciates your focus on complete compliance, with all aspects of the tax law, by all classes of taxpayers, including those designated as "tax-exempt." Even charities and tax-exempt entities have employment tax obligations, a point I will elaborate on in a moment. Commissioner Everson has established the enhanced enforcement of the tax law as one of the three goals of his tenure as Commissioner of Internal Revenue. Further, he has specifically identified, as a principal objective of this goal, the task of deterring abuse within tax-exempt and governmental entities and the misuse of such entities by third parties for tax avoidance or other unintended purposes.

In furtherance of these goals, the Commissioner has, in recent years, requested additional resources for enforcement generally. Within TE/GE, we have concentrated the new resources we have received in two of our functions, Exempt Operations (EO) and Federal, State and Local Governments (FSLG). In FY 2001, we had 812 FTE in EO and 50 FTE in FSLG. In 2005, those numbers had increased to 845 and 100, respectively. EO and FSLG are the functions in TE/GE where we most often address employment tax issues. We have also used these resources to address a number of serious problems within the tax-exempt sector. These include, for example, the abuse of tax-exemption by credit counseling organizations, the practice of executives of some charities awarding themselves excessive compensation packages, and the improper intervention by charities in political campaigns.

This morning, I would like to begin with an overview of the law governing employment tax, with an emphasis on how it applies to exempt organizations. Next, I will discuss the IRS's enforcement and collection efforts in this area. In doing so, I will discuss the Combined Annual Wage Reporting program (CAWR), which involves cooperation between the Social Security Administration (SSA) and SB/SE. I will also discuss TE/GE specific programs that address employment tax among tax-exempt and governmental entities. Finally, I will briefly speak of our future plans for enforcement in this area.

II. Applicable Law

Overview of Employment Tax Requirements

Let me begin with the applicable law. What follows in this section of my testimony is a broad discussion of the main employment tax obligations imposed on employers. There are many specific details and exceptions that affect the amount of an employer's liability and how the employer goes about reporting and paying the tax.

In general, employers are required to pay employment taxes on wages, and to report wages and certain other payments to the IRS. Federal employment taxes include three components: (i) federal income tax withholding, (ii) social security, and Medicare taxes (the Federal Insurance Contributions Act "FICA" taxes), and (iii) the Federal Unemployment Tax Act (FUTA) tax. Employers are required to make deposits of employment taxes on a daily, semi-weekly, monthly or quarterly schedule, depending upon the amount of tax they accumulate for deposit.

For purposes of today's discussion, it is important to note that charities described in section 501(c)(3) that are exempt from income tax under section 501(a), as well as Federal, state and local government agencies and instrumentalities, are not liable for taxes under the FUTA. This is a significant distinction from other employers.

Determining Liability for Tax

The first step in evaluating liability for federal employment taxes is to determine whether a worker is an employee or an independent contractor. The Code applies the multi-factor common law test for this purpose. Under the common law test, an employer-employee relationship exists when the person for whom the services are performed has the right to control and direct the individual who performs them. More detailed information is available in Independent Contractor or Employee? Training Materials (1996), issued by the IRS and available on the IRS web site at <http://www.irs.gov/pub/irs-utl/emporind.pdf>. Employers are generally liable for employment taxes, and the associated withholding, reporting and deposits, on the wages they pay their employees.

Employers are also required to withhold and pay the employee portion of social security taxes (currently 6.2 percent of wages up to the maximum wage base, which is \$94,200 for 2006) and Medicare taxes (currently 1.45 percent of all wages) from payments of wages, and to pay the equivalent employer portion of social security and Medicare taxes with respect to wages paid to the employees. If the employer fails to withhold the proper amount of income tax or the employee portion of social security or Medicare taxes from wages paid to the employee, the employer remains liable for such tax.

The law provides exceptions from the general rules for certain employers. We will discuss the special rules for charities below, but will first note that there are also special rules that apply to governments. For example, state and local government workers are not subject to social security tax if they are otherwise covered by a retirement system providing a benefit similar to social security. A state or local government employee will be exempt from the Medicare tax if the employee has been continuously employed by the same employer since 1986, and is also covered by a retirement system. Additionally, Federal employees hired before January 1, 1984, are generally not subject to social security tax. These exceptions do not apply for purposes of income tax withholding.

How employment tax is paid

Employers are required to withhold income tax from wages in accordance with tables provided by the IRS and published in Publication 15, Circular E, and Employer's Tax Guide, which is updated at least annually and is found at the following URL: www.irs.gov/pub/irs-pdf/p15.pdf. If the employer fails to withhold income tax, and the employee does not pay the income tax, the employer remains liable for the missing withholding.

In general, employers must pay federal employment tax by depositing federal income tax withholding and both the employer and employee social security and Medicare taxes. In calculating the amount to be deposited the employer must take into account any adjustments to tax liability for prior periods and the amount of any advance earned income credit payments. The liability for employment tax arises when the wages are paid. If an employer accumulates \$100,000 or more of employment tax liability, the employer must deposit the employment taxes by the end of the next business day. Less frequent deposits are required for smaller liabilities. Some employers are required to deposit using the Electronic Federal Tax Deposit System (EFTPS).

Filing of Tax Returns and Information Reporting

In addition to determining the liability for employment taxes and making timely deposits, employers are responsible for filing appropriate tax and information returns. Employers are required to file Form 941, Employer's Quarterly Federal Tax Return, reporting liability for Federal income tax withholding, social security, and Medicare tax on a quarterly basis. Beginning January 1, 2006, employers with an estimated annual employment tax liability of \$1,000 or less may file the new Form 944 (Employers Annual Federal Tax Return) once a year rather than filing Form 941 four times a year. The IRS mailed notification letters between February 1 and February 15, 2006 to eligible small employers for calendar year 2006.

Employers must also provide each employee with a copy of his Form W-2 for the preceding year by January 31. Employers are required annually to file Form W-3, Transmittal of Wage and Tax Statements, with the Social Security Administration along with copies of the Forms W-2 for all employees.

All taxpayers are required to maintain the records necessary to support the information submitted on their tax returns. If an employer discovers that it has made a mistake in computing its social security and Medicare tax liability in a prior tax return, IRS procedures call for the employer to amend its returns and pay any social security and Medicare taxes that it owes. Under Code section 6205, adjustments related to the FICA tax are made "interest free" on a subsequent Form 941 with an attached Form 941C explaining the adjustment. Generally, this rule applies for errors related to income tax withholding only if the error is discovered within the same calendar year.

IRS procedures also call for the employer to provide the employee with a corrected Form W-2.

Personal liability for employment taxes

Section 6672(a) of the Code imposes a liability equal to the amount of unpaid "trust fund taxes" upon any person responsible for collecting, accounting for or

paying over such taxes who willfully fails to do so. "Trust fund taxes" include income tax withholding and the employee portion of social security and Medicare taxes.

Special Rules Applicable to Exempt Organizations

If an exempt organization has employees, it is responsible for federal, state, and local taxes. Exempt organizations follow the same employment tax filing and reporting requirements as non-exempt organizations, with two exceptions. The first applies to exempt organizations that are exempt from income tax under section 501(c)(3) of the Internal Revenue Code. Such an organization is also exempt from FUTA. This exemption cannot be waived.

The second exception applies to churches, and concerns all three employment taxes: withholding, FICA and FUTA.

Churches are not required to withhold income tax on compensation paid to ministers for performing services in the exercise of their ministry, although a minister may request voluntary income tax withholding. Whether tax is withheld or not, the church reports the minister's compensation on Form W-2, if the minister is an employee, or on Form 1099, if the minister is an independent contractor. If the minister is the only employee, the church may have no form 941 requirement.

Churches are required to withhold income tax for their other employees, and the general rules apply for determining whether a worker providing services is an employee or an independent contractor. The Church reports an employee's compensation on Form W-2, or issues a Form 1099 for an independent contractor.

Churches are also not required to withhold or pay FICA taxes on compensation paid to ministers for performing services in the exercise of their ministry. However, a minister is subject to SECA, unless he or she applies timely for an exemption on the basis of his or her religious beliefs.

Other church employees are subject to FICA unless the church pays the employee less than \$108.28 in a calendar year or the church applies for an exemption from FICA due to religious reasons. If a church makes such an election not to pay FICA, the employees are subject to SECA.

Churches, like other 501(c)(3) organizations, are not subject to the FUTA tax for any of their employees.

Is Failure to Pay Employment Tax a Cause for Revocation of Tax-Exempt Status?

Under section 508 of the Code, a charitable organization wishing to obtain tax-exempt status, must apply to the IRS for exemption. These applications come to TE/GE's EO unit, where they are reviewed. If the applicant demonstrates its eligibility for exemption, we issue it a determination letter recognizing its tax-exempt status.

Under section 508(c), churches, their integrated auxiliaries, and conventions or associations of churches are not required to complete this determination process.

Exempt status, once recognized, can be lost. The IRS is authorized to, and does, revoke the tax-exempt status of organizations that cease to act in pursuance of an exempt purpose, or that violate specific provisions of the Code pertinent to tax-exempt status. For example, section 501(c)(3) prohibits, among other things, inurement or participation or intervention in political campaigns. As I mentioned a moment ago, TE/GE is conducting enforcement programs aimed at organizations that violate these prohibitions.

Compliance with employment tax rules is not, in general, a requirement for continuing recognition as a tax-exempt organization. In exceptional circumstances, revocation of section 501(c)(3) exempt status for violation of employment tax provisions, while an extraordinary measure, may be warranted where the violation of employment tax law is so substantial that the organization can be found to have a substantial non-exempt purpose. Available records do not indicate that we have revoked the tax-exempt status of any organization solely because of employment tax non-compliance.

The facts of the case would be critical in any case where such a revocation was contemplated. For example, if the unpaid employment taxes are being pocketed by individuals for their personal enrichment, it is likely that a private benefit or inurement issue is present that may warrant revocation. However, if the organization does not pay the employment taxes because the organization is short of money and chooses to use that which it has to meet net payroll and to further its exempt purpose, then the failure to pay may not rise to the level of a violation of the operational test.

III. IRS Compliance Efforts Directed at Charities

As I noted in the introduction, two operating divisions of the IRS are primarily responsible for enforcing the payment of federal employment taxes by charities: SB/SE and TE/GE.

To encourage and enforce compliance by tax-exempt entities with the requirements of employment tax law, we begin with customer education and outreach and follow-up with document matching, examinations, collections, and traditional forms of enforcement. I'd like to begin this portion of my testimony by discussing TE/GE's customer education and outreach programs for tax-exempt entities, and then move to a discussion of IRS enforcement efforts.

A. Outreach and Education.

Exempt Organizations

TE/GE's Exempt Organizations (EO) function conducts a vigorous customer education and outreach program to educate charities and other exempt organizations about their tax responsibilities, including their employment tax obligations. This effort is especially important for small and mid-sized organizations, whose officials may not be experienced in business operations. EO includes information about employment tax obligations in its plain language publications, notably Publication 4221, *Compliance Guide for 501(c)(3) Tax-Exempt Organizations*, Publication 1828, *Tax Guide for Churches and Religious Organizations*, and Publication 557, *Tax-Exempt Status for Your Organization*. EO also addresses employment taxes in workshops and via the internet.

For example, in EO's Small and Mid-sized Exempt Organizations Workshop program, offered in six cities across the country each year, we include a session on Employment Taxes as one of five parts of the day-long workshop. The session has three objectives:

- Identify the main factors used to categorize a worker as either an employee or an independent contractor;
- Identify the workers that are statutorily classified as employees and those that are statutorily classified as independent contractors; and
- Introduce the major employment tax forms and their uses for the typical small EO.

During the presentation, attendees participate in an Employment Issues Quiz, which reviews the concepts covered in the session. Each attendee also receives a copy of the Small and Mid-sized EO Workshop Textbook, which includes a chapter on Employment Taxes. Next year, we will also make those workshops available on a CD, while continuing to offer the program in certain cities.

With respect to the internet, employment taxes are a prominent component of the interactive "Life Cycle of a Public Charity" and "Life Cycle of a Private Foundation" features that appear on EO's external web page. The Life Cycle features are easy-to-use guides that provide a general discussion of the basic requirements for reporting, withholding, and depositing employment taxes, the distinction between independent contractors and employees, and the e-filing

options for exempt organizations. Importantly, they also provide links to more detailed information and additional resources, as well as to all necessary forms.

EO advertised the availability of the employment tax web site to all members of the EO e-mail subscription list, [EO Update](#), which currently has almost 12,000 subscribers, and placed an article about it in the Social Security Administration newsletter, the *SSA Reporter*, which reaches both employers and employees.

Government Entities

TE/GE's Government Entities (GE) function also conducts a strong customer education and outreach effort about employment taxes. In two of GE's three functional units – Federal, State and Local Government (FSLG), and Indian Tribal Governments (ITG) – a primary concern has been to improve compliance with employment tax law within the governmental and tribal communities. During the period FY 2001 – 2005, GE employment tax educational efforts included 4,069 events that reached 150,969 participants. In addition to these face-to-face events, FSLG and ITG have established a substantial educational presence on the internet. This includes:

- Employment tax Frequently Asked Questions directed towards the unique needs of the governmental and tribal communities;
- Electronic publications, such as the ITG *Employment Tax Desk Guide* and the FSLG *Federal-State Reference Guide*;
- Electronic newsletters on current law changes impacting the communities;
- An “Ask-us” mailbox for general questions primarily relating to employment tax compliance.

B. Enforcement

The IRS's enforcement program with respect to employment tax obligations of tax-exempt entities may be divided into two categories. The first is the Combined Annual Wage Reporting (CAWR) and other programs which SB/SE operates. The second is the examination program run by the EO function of TE/GE, including initiatives and special programs.

CAWR

The IRS and the Social Security Administration (SSA) jointly administer the CAWR program. The CAWR matches reported earnings and reported withholding of taxes. As noted, employers are responsible for withholding income, Social Security, and Medicare taxes from their employees' wages. They must pay over the amounts withheld and file Form 94X series returns (Forms 940, 941, and 945) with the IRS.

The employer is also required to file Form W-2 Wage and Tax Statements for each employee, and Form W-3 (Transmittal of Income Tax Statements) with SSA. Correct Forms W-2 should include the same information summarized quarterly on the Forms 94X, while the Form W-3 summarizes the Forms W-2.

Ideally, all information reported on Forms 94X should match the information on Forms W-2 for a given year. The IRS, working with SSA, maintains three programs in this area. The first two, SSA CAWR and IRS CAWR, deal with instances where the Agencies have received all returns but there is a mismatch in the information reported. The third program deals with instances where the IRS does not have a Form 94X to match with the SSA data. In this testimony, we will refer to this third program as the CAWR Referral Program.

The SSA CAWR program resolves discrepancies between information (tax and credits) reported on Forms W-2 and W-3 information returns and data reported on the series 94X returns. Cases normally involve situations where the 94X reports higher wages than the Forms W-2 and W-3. The purpose of this program is to reconcile SSA accounts. SSA refers cases to the IRS where the employer fails to respond to two SSA inquiries. Under an agreement between the IRS and SSA, the IRS pursues all SSA CAWR cases. We may assess penalties where the discrepancy cannot be resolved.

Under this program, SB/SE pursues all of these SSA referrals without regard to what type of taxpayer is involved, whether it is a charity, government or a for-profit business.

Of the 157,355 SSA CAWR cases and closures in 2005, some 11,396 (7.2%), were TE/GE taxpayers. Of these, it appears that at least 7,700 were section 501(c)(3) organizations.

The second program is the IRS CAWR. This portion of CAWR resolves discrepancies between information (tax and credits) reported on the series 94X returns and the data reported on Forms W-2 and W-3 information returns. Where amounts reported on forms W-2 and W-3 are greater than those reported on Form 94X, IRS may assess additional tax and penalties where the discrepancy cannot be resolved.

Like the SSA CAWR, this work is done by tax examiners at several CAWR units at Service Centers, and is undertaken on behalf of the entire IRS. Unlike the SSA CAWR, IRS CAWR work is not mandatory, and therefore not all cases are pursued. Charities are selected and pursued using the same criteria as other IRS taxpayers. The criteria for selection are based generally on the amount of the assessments involved.

For 2005, of the universe of 659,717 IRS CAWR cases, 60,013 (9.1%) were TE/GE taxpayers. Of the 166,619 closures, 18,598 (11.2%) were TE/GE cases.

Thus, approximately 25% of all IRS CAWR cases, and 31% of TE/GE IRS CAWR cases were pursued. Of the TE/GE closures, more than 12,400 were entities described in section 501(c)(3).

CAWR Referral Program – Potential Form 941 Non-filers. The CAWR Referral Program concerns mismatches that occur when SSA has received Form W-3 & W-2 records from an employer, but the IRS has no record of a 941 being filed. These mismatches are posted to a database accessible by relevant operating divisions of the IRS, including TE/GE. The table below sets out the number of referrals. Unlike the SSA CAWR and IRS CAWR programs, SB/SE refers these cases to the other Operating Divisions for consideration.

CAWR Referral Activity

<u>Year</u>	<u>SB/SE</u>	<u>TE/GE</u>	<u>LMSB</u>	<u>Total</u>
FY03 (tax year 2001)	64,226	4,367	3,558	72,151
FY04 (tax year 2002)	59,346	4,432	3,646	67,424
FY05 (tax year 2003)	51,735	3,935	2,183	57,853
Projection FY06 (tax year 2004)	53,647	3,950	3,113	60,710

TE/GE cases placed on the database include all TE/GE taxpayers: governments, tribes, exempt organizations, and pension plans. A review of the referrals indicates that by far the largest dollar amounts of these mismatches relate to governmental taxpayers and pension plans. The review also shows that well over half of the referrals are churches that appear to have no Form 941 reporting requirement.

The potential value of tax owed by all TE/GE entities on the CAWR database has declined dramatically. For 2001, the value of the tax owed cases was \$1.29 billion. This declined to \$1.16 billion for 2002, \$356 million for 2003, and \$180 million for 2004, the most current year. Of this \$180 million, the potential value of tax owed by 501(c)(3) organizations is \$17 million.

This large decline reflects in part, we believe, the significant attention that TE/GE, and in particular its Federal, State, and Local Governments unit (FSLG), has devoted to employment tax cases. FSLG uses the CAWR referral database, as well as other CAWR data, in its case selection work.

EO has not used the CAWR database. Instead, it pursued Form 941 non-filers through the use of Form 990 information returns. In 2002 and continuing until recently, EO used an automated system to select for examination organizations that reported salaries, wages, or executive compensation on the Form 990, but showed no filed Form 941 for the corresponding periods. EO conducted more

than 800 examinations as part of this project. EO initiated the program because it believed that this set of circumstances was likely to identify high potential noncompliance. However, examination results did not support this hypothesis. We therefore discontinued the program and began work to find improved methods of case selection. As part of this effort, we will begin using CAWR referrals and other CAWR data as part of a broader case selection process through an automated system similar to that used by FSLG. EO also is working on an improved computer-based modeling system to help select productive employment tax examination cases. This new system, which uses all available data, including CAWR data and examination results, will be piloted this winter.

TE/GE -- EO Examination Program

TE/GE's EO function contains an examination unit, EO Examinations. In five years, EO Examinations has grown from 432 FTE in 2001 to 472 FTE in 2005. The examination of exempt organization employment tax returns is integrated into EO's general examination program, and it is within this structure that most EO employment examinations are conducted.

In 2006, EO Examinations plans to close 6,100 returns of exempt organizations. In conducting these examinations, when the preliminary review indicates that further inquiry is appropriate, the agent obtains and conducts an examination of the exempt organization's employment tax returns. This has resulted in EO Examinations closing more than 1,200 employment tax returns of exempt organizations in each recent year.

The number of employment tax examination closures does not fully reflect the level of effort in the employment tax area because we evaluate whether to open an employment tax audit in most of our exempt organization examinations. However, unless a problem surfaces, time spent on this review is not reflected in our examination data systems because the agent does not open a formal employment tax examination. We have also created correspondence units whose work is accounted for separately.

In EO, we select employment tax cases in several ways. We selected most of our employment tax cases as part of an examination of other returns. Beyond that, we have a number of initiatives and special projects that address employment taxes. I will discuss each of these in turn.

Required Review of Exempt Organizations' Employment Tax Filings

Within EO, we examine exempt organizations' compliance with employment tax obligations as part of standard exempt organization audits. We do this by following our EO Examinations "Required Filing Checks" – that is, a guide to the elements we expect an agent to review in the course of an audit.

Exempt Organization examinations ordinarily include a “Required Filing Check” to determine if the organization is in compliance with all federal tax return filing requirements – including employment tax returns -- and whether all returns report substantially correct tax. When warranted, we expand the examination to focus on specific returns.

Required Filing Checks address employment tax (including questionable Form W-4 procedures), excise tax, information returns, pension plan returns, and Forms 8300. The specific forms include:

- Form 940, Employers Annual Federal Unemployment (FUTA) Tax Return
- Form 942, Employer’s Quarterly Federal Tax Return
- Form W-2, Wage and Tax Statement
- Form W-4, Employee’s Withholding Allowance Certificate
- Form 1096, Annual Summary and Transmittal of U.S. Information Returns, including Form 1099 series
- Form 1120-POL, U.S. Income Tax Return for Certain Political Organizations
- Form 4720, Return of Certain Excise Taxes on Charities and other persons under Chapters 41 and 42 of the IRC
- Form 5500 series, Annual Return/report of Employee Benefit Plan
- Form 8300, Reports of Cash Payments Over \$10,000 Received in a Trade or Business.

When EO decides to open an employment tax exam, as a result of the Required Filing Check process, we first insure that the tax has not already been paid, and that it has not been filed under an incorrect EIN number. When these preliminaries are completed, we open the case

Initiatives and Special Programs

Beyond its standard examination program, Exempt Organizations also conducts initiatives and special programs that focus on compliance with employment tax requirements by specific classes of exempt organizations. We have already discussed the EO Form 941 matching program. Another example of an employment tax initiative is the Medical Residents FICA program. The issue here is whether the medical residents are students employed by a school, college or university, and therefore exempt from FICA, or not. The IRS has taken the position that medical residents are subject to FICA, and that position has been strenuously challenged. We have won a case in a federal district court in the 11th Circuit, but lost two cases in the 8th Circuit on this question. The district court case in the 11th Circuit is now on appeal. We have a large number of claims pending in this area as well.

Another example of such an initiative involves the failure of some colleges and universities to comply with the withholding tax regulations on payments (such as wages, grants, scholarships and other income) to non-resident alien students, faculty and researchers. Under prior programs, we allowed taxpayers to voluntarily come in to us to resolve problems in this area. Subsequently, we decided to follow-up to see if compliance had improved after our educational and voluntary compliance programs. We conducted 12 examinations and 319 compliance checks. The change rate on the examinations was 92%. In the compliance checks program, delinquent returns were secured in 38% of the cases. After this program was completed, a research team took a second look to determine whether there was improvement in the filing of the required forms by the taxpayers involved. The team found a marked improvement. All but 8 of the colleges and universities were in compliance. More work in this area will occur in 2007.

A third initiative involves the use of one of EO's new enforcement units, the EO Compliance Unit (EOCU). This project focuses on exempt organizations that have filed a Form 941 showing a specific level of wages, but not a Form 990. In such cases, we would expect an organization that filed a 941 to also file a Form 990. The EOCU is conducting compliance checks on a statistically-valid sample of 654 cases for tax years 2002 and 2003 to look into this situation.

III. Collection Practices

Another important part of the IRS's over-all employment tax enforcement strategy is the collection program for tax-exempt taxpayers. SB/SE conducts this program on behalf of TE/GE, as it does for the entire IRS. This section of the testimony describes the volume of TE/GE collection cases, the notice process and its effectiveness, and the manner in which cases are selected for individual collection actions.

The figures presented in this section include all TE/GE taxpayers. They include government agencies, Indian tribes, pension plans, and non-profits as well as charitable organizations. Our collection activity reports do not separate out these individual categories in greater detail.

It should be noted that in determining who to pursue in the collection process, SB/SE does not consider whether the taxpayer is a TE/GE taxpayer. Thus, TE/GE taxpayers, including charities, are treated in a manner similar to all other taxpayers.

To begin the Collection process, all entities showing a balance due are automatically contacted by notice sent from our Service Centers. In FY 2005 a total of 282,049 first notices were issued on balance-due accounts of TE/GE taxpayers. This amounts to about 2% of the more than 13,870,000 first notices

issued to all types of taxpayers that year. About 53% of the TE/GE accounts are resolved by the taxpayer's self-correction before the fourth or final notice is issued.

A total of 131,669 TE/GE accounts required a fourth notice. (Of these 68,390, or about 52%, involved employment tax (trust fund) delinquencies.) About 49% of all fourth notices are resolved in that status.

Some 64,801 TE/GE accounts associated with 27,452 taxpayers continued into delinquent status for potential contact by telephone or by a revenue officer in the field. After application of certain screening criteria, 26,884 TE/GE accounts associated with 6,498 taxpayers met the criteria for assignment to the field for personal contact by a revenue officer.

At the end of FY 2005, 26,007 accounts, representing \$250 million in assessed balances due, were in the queue awaiting assignment. Of these 1,407 accounts -- or 5% -- represented nearly half of the total dollars due. The average balance due of the remaining 24,600 accounts was \$5,335.

As indicated, no distinction is made with respect to the type of taxpayer when prioritizing cases for assignment to employees in the call sites, or in the field for personal contact. As these employees are available for new work, cases are assigned according to a risk-based process. Although the process is complex, and there are some minor exceptions, generally the priorities are set with a focus on three factors:

- a. The type of tax being collected, which weighs more heavily toward employment taxes;
- b. The age of the delinquency; where the newest delinquency receives the higher priority; and
- c. The amount due; where the priority increases as more money is involved.

The absence of figures relating exclusively to exempt organizations' accounts makes difficult a precise evaluation of the IRS's collection program for exempt organizations employment tax. It is clear, however, that such cases are pursued, according to the same criteria that apply to other types of collection cases. Thus, the employment tax obligations of tax exempt organizations are pursued.

IV. Future Plans

Within the IRS, and within TE/GE, we have been hard at work on improving compliance with employment tax obligations across the board, and we have achieved some noteworthy successes, particularly with respect to potential tax due from Federal, state and local governments.

We continue to look for ways to improve charities' compliance with employment tax law, and to improve our collection of employment taxes owed but unpaid. We want, of course, to collect the tax, but we also hope that by developing better methods of detecting non-compliance in the employment tax area, we also will be able to detect non-compliance in other areas of the tax law related to charities.

With that in mind, we continue to develop new processes in the employment tax area.

Data Mining and Modeling Project

TE/GE currently has underway an initiative to develop a "risk model" that will detect, classify and quantify high risk compliance patterns. When completed in late September, EO Examinations will pilot the use of this risk model in selecting taxpayers for examination. In developing the risk model, all available sources of data are being evaluated that could be helpful in identifying organizations likely to be non-compliant.

One aspect of the model focuses on identifying exempt organizations that are not fully meeting their employment tax obligations.

The primary source of the data to be used is our RICS classification system. RICS is a database and search engine that includes information for all exempt organizations that file, or are required to file, Forms 990 or 990 PF returns. RICS also includes information on related returns (including Forms 940 and 941) filed by these exempt organizations, and audit history information on taxpayers previously examined. One of the other data sources we are exploring for possible use in this project is the Combined Annual Wage Reporting (CAWR) system, discussed above. We hope this will allow us to be increasingly proactive in our selection of non-compliant charities, including those that are not meeting their employment tax obligations.

Expansion of Information Available for Case Classification

As mentioned, RICS is a TE/GE computer system that analyzes data about TE/GE taxpayers to help TE/GE classification staffs select the most appropriate TE/GE taxpayers for examination, or to identify appropriate remedies for specific taxpayer situations. RICS can effectively analyze multiple databases.

With this in mind, TE/GE is working to enlarge RICS' accuracy and usefulness by expanding RICS' access to relevant databases. Last year, RICS gained access to updated Business Masterfile (BMF) data, as well as to all CAWR data. TE/GE is now exploring best practices for querying and using this data to select productive cases for examination.

Access to these databases will also allow us to identify situations that require our attention but do not rise to the level of a full examination.

TEGE classifiers are being trained and gaining experience with these new data sources, and this process will continue into the future. When fully familiar with the characteristics of the new BMF and CAWR databases, TE/GE classifiers will be able, among other things, to:

- Identify situations where no return has been filed but substantial tax deposits have been made (a situation amenable to resolution by “soft” contact rather than examination).
- Identify situations where a taxpayer thought to be delinquent has recently filed a return, and an examination would not be necessary.
- Identify situations where a taxpayer is working with Collections, and initiation of an examination would be inappropriate.

V. Conclusion

In sum, the IRS, using resources primarily from SB/SE and TE/GE, has a considered program for enforcing the employment tax law as it applies to charities.

While the law does not generally permit us to revoke a charity’s tax-exempt status for its failure to comply fully with employment tax law, it does give us other tools to insist that charities meet their employment tax obligations, and we have active programs in place to do that. This said, we believe that as we improve selection techniques, we will be able to increase our coverage in this important area.